FRBSF WEEKLY LETTER

Number 92-37, October 23, 1992

Southern California Banking Blues

The banking industry's performance historically has been closely related to the condition of the economy. This certainly has been true during the most recent recession in California. Since the downturn in the state's economy after mid-year 1990, problem loan ratios have risen sharply and bank earnings have deteriorated.

Within the state, the economic strains have not been evenly distributed. As pointed out in the *Letter* of August 21, 1992, the impact of the recession has been more severe in Southern California. As a result, the smaller community banks operating there generally have faced a much harsher economic climate than either community banks elsewhere in the state or the larger banks that operate throughout the state.

This *Letter* illustrates the uneven impact of the recession within California by comparing the performance of the community banks operating in Southern California with community banks in two other key regions of the state, the Central Valley and the San Francisco Bay Area.

The California economy

The California economy continues to struggle, burdened by the sluggish national recovery, ongoing defense cutbacks, and soft real estate markets. Employment in the state has declined by 650,000 jobs since the mid-year 1990 cyclical peak. This huge loss of jobs is a major reason why California's September unemployment rate stood at 9.4 percent, far above the U.S. average of 7.5 percent.

The severity of the economic downturn in California is reflected in the performance of the state's banks. After large losses in the last half of 1991, aggregate earnings for the state's banks were positive during the first half of 1992, with return on assets (ROA) climbing to 0.54 percent; but bank performance still lagged far behind the improvement at the national level. ROA for the nation rose to 0.92 percent for the first half of the year. Nationally, only 6.4 percent of U.S. banks reported losses for the first half of 1992, while in California 24 percent of the banks reported losses. Moreover, asset quality, measured by the ratio of problem loans to total loans, registered significant improvement almost everywhere *except* California.

Southern California suffers

Much of the slowdown in the California economy has taken place in Southern California. Together six major Southern California counties have lost over 520,000 jobs since the peak in employment in May 1990, accounting for most of the state's job loss.

Commercial real estate markets in California also have been hit hard by the aftermath of the 1980s building boom. As with the employment figures, the commercial real estate situation appears to be worse in Southern California than in other subregions. According to Coldwell Banker, as of June 1992, vacancy rates for commercial office space in metropolitan areas were near or above the national average of 19.4 percent in each of the Southern California markets. In the Central Valley, only Bakersfield exceeded the U.S. average, while vacancy rates in all the San Francisco Bay Area markets were well below the U.S. average.

Local economies and community banks

Given the severity of the recession in Southern California, the exposure of community banks to local economic conditions is particularly important. In contrast to the larger banks, which often have statewide branching networks, the smaller community banks have only limited ability to diversify beyond their local communities. Thus, community banks generally find their fortunes more closely related to the economic vitality of regions of the state where they are located. As of June 1992, 386 of the state's 459 banks fit the description of community banks, defined here as institutions with assets of less than $300 million.

WESTERN BANKING *Western Banking* is a quarterly review of banking developments in the Twelfth Federal Reserve District. It is published in the *Weekly Letter* on the fourth Friday of January, April, July, and October.

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Analysis of aggregate data by subregion for community-oriented California banks allows us to examine variations in banking conditions in three major areas of the state. The first subregion is Southern California (Los Angeles, Orange, Riverside, San Bernardino, San Diego, and Ventura Counties), with 222 community banks; the second is the San Francisco Bay Area (Alameda, Contra Costa, Marin, San Francisco, San Mateo, Santa Clara, Solano, Sonoma, and Napa Counties), with 74 community banks; the third is the Central Valley (Fresno, Kern, Sacramento, and San Joaquin Counties), with 31 community banks.

Problem loans and earnings

Two measures of industry performance are examined: problem real estate loan ratios and return on assets. As California's economy has deteriorated over the past two years, problem real estate loan ratios (defined here as all loans 30 days or more past due plus loans no longer accruing interest divided by outstanding loans) have risen sharply. Problem loan ratios for construction and commercial real estate lending have soared as office and commercial vacancy rates have climbed, rents have fallen, and cash flows have been squeezed. These problems are especially noteworthy since 38 percent of community banks' total loans are for construction and commercial real estate. The comparable ratio for all California banks is only 25 percent.

The worst deterioration in real estate loan quality in the three subregions has taken place at Southern California community banks. As shown in Chart 1, the ratio of problem real estate loans at community banks in Southern California has been above 7 percent for the last three quarters, and at mid-year it was more than double the ratio for the Central Valley. Moreover, asset quality problems extend beyond real estate lending, as problem loan ratios for total, business, and consumer installment loans also are the highest in Southern California.

Return on assets data shown in Chart 2 for the three California subregions emphasize the deterioration of community bank performance in Southern California from prerecession levels. For example, ROA for the first half of 1992 was a dismal 0.26 percent for Southern California community banks, compared to 0.61 percent for Northern California and 0.71 percent for the Central Valley. Moreover, the share of banks losing money in the first half, at 28 percent in Southern California, also was higher than the comparable figures for the San Francisco Bay Area (23 percent) and the Central Valley (10 percent).

Chart 1
Problem Real Estate Loan Ratio
for Community Banks

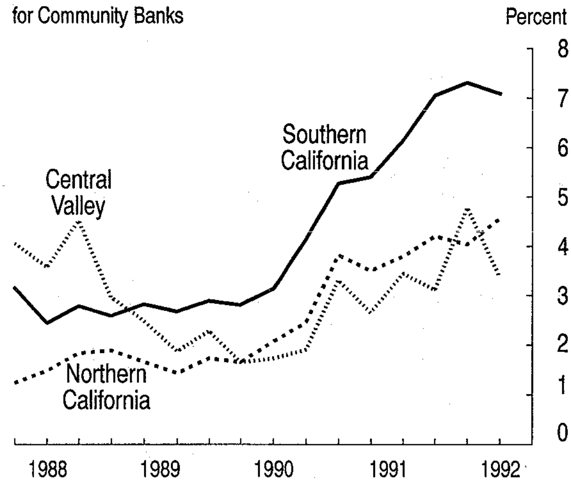
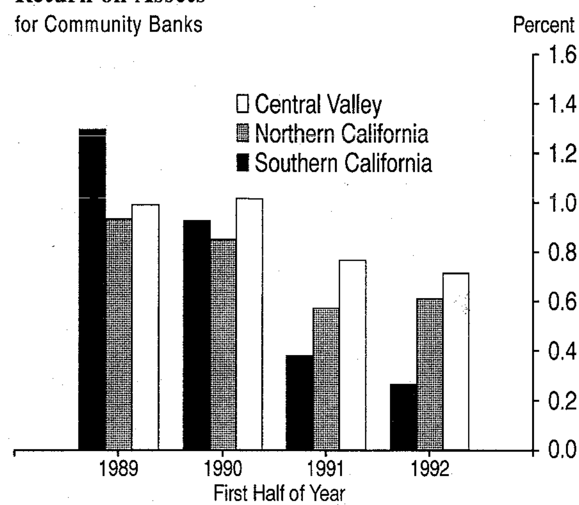


Chart 2
Return on Assets
for Community Banks



Outlook remains variable and cloudy

Asset quality and earnings for community banks show a pattern of deterioration that is consistent with the weakness in the California economy over the last two years. Southern California's community banks have experienced more loan quality problems and have suffered more earnings deterioration than have community banks in the other subregions. Furthermore, the continued problems in commercial real estate lending and prospects for an "overhang" of office space until the end of the decade, as some analysts have suggested, argue against a quick improvement in the important Southern California banking market.

Gary C. Zimmerman
Economist

REGIONAL BANK DATA

JUNE 30, 1992

(NOT SEASONALLY ADJUSTED, PRELIMINARY DATA)

		DISTRICT	ALASKA	ARIZ.	CALIF.	HAWAII	IDAHO	NEVADA	OREGON	UTAH	WASH.
ASSETS AND LIABILITIES -- $ MILLION (ALL COMMERCIAL BANKS)											
ASSETS	TOTAL	501,742	4,585	35,298	335,816	21,330	9,679	14,455	25,734	14,049	40,796
	FOREIGN (RESIDUAL)	29,014	0	0	26,849	1,992	0	0	0	108	65
	DOMESTIC	472,728	4,585	35,298	308,967	19,338	9,679	14,455	25,734	13,942	40,730
LOANS	TOTAL	347,006	2,093	19,414	239,474	13,444	6,654	9,135	17,996	8,780	30,016
	FOREIGN (RESIDUAL)	29,223	3	0	27,824	1,345	0	0	0	0	51
	DOMESTIC	317,783	2,090	19,414	211,650	12,099	6,654	9,135	17,996	8,780	29,965
	REAL ESTATE	167,913	891	7,171	124,994	6,912	2,059	2,679	6,968	3,309	12,929
	COMMERCIAL	66,107	716	2,598	43,314	3,190	1,529	866	4,637	1,678	7,579
	CONSUMER	56,713	336	5,375	29,457	1,150	1,816	5,177	3,611	3,176	6,615
	AGRICULTURE	5,965	6	372	2,941	44	804	15	491	154	1,138
	INTERNATIONAL	92	0	7	84	0	0	0	0	0	0
SECURITIES	TOTAL	61,296	1,894	6,734	33,332	4,260	1,771	2,386	3,827	3,135	3,957
	U.S.T.S.	20,020	819	2,272	9,975	2,030	423	1,286	1,112	636	1,466
	SECONDARY MARKET	29,882	570	3,590	17,775	1,644	845	655	1,825	1,749	1,229
	OTHER SEC.	11,394	505	871	5,582	585	503	445	890	751	1,262
LIABILITIES	TOTAL	464,178	3,983	32,347	312,364	19,818	8,971	12,974	23,496	12,850	37,376
	DOMESTIC	435,164	3,983	32,347	285,515	17,826	8,971	12,974	23,496	12,743	37,311
DEPOSITS	TOTAL	403,741	3,420	29,849	274,304	15,579	7,494	9,197	19,972	10,467	33,462
	FOREIGN (RESIDUAL)	27,874	0	0	25,228	1,787	0	0	0	108	751
	DOMESTIC	375,868	3,419	29,849	249,076	13,791	7,494	9,197	19,972	10,359	32,711
	DEMAND	86,738	973	5,573	61,110	2,210	1,291	2,246	3,859	1,934	7,540
	TIME AND SAVINGS	289,130	2,446	24,275	187,967	11,581	6,203	6,950	16,112	8,425	25,171
	NOW	39,407	302	3,186	24,216	1,494	927	1,143	2,950	1,383	3,805
	MMDA	91,276	518	7,632	63,893	1,997	1,422	2,321	4,156	1,851	7,486
	SAVINGS	41,622	609	2,568	26,652	2,807	776	1,536	1,943	1,273	3,459
	SMALL TIME	77,251	512	9,210	44,465	2,162	2,495	1,132	6,094	3,138	8,043
	LARGE TIME	39,127	475	1,679	28,530	3,119	582	816	927	776	2,224
OTHER BORROWINGS		38,480	520	1,995	20,131	3,665	1,378	2,929	2,872	2,189	2,802
EQUITY CAPITAL		37,564	601	2,951	23,452	1,512	708	1,481	2,239	1,199	3,420
LOAN LOSS RESERVE		10,467	41	562	7,866	221	100	369	467	217	625
LOAN COMMITTMENTS		188,939	602	19,206	126,203	5,909	2,480	1,796	9,446	6,817	16,480
LOANS SOLD		27,591	6	156	23,715	225	25	40	230	53	3,140
EARNINGS AND RETURNS -- $ MILLION, YEAR-TO-DATE (ALL COMMERCIAL BANKS)											
INCOME	TOTAL	22,644	210	1,304	15,071	897	437	1,039	1,235	704	1,746
	INTEREST	18,035	172	1,031	11,968	802	376	751	968	579	1,388
	FEES & CHARGES	1,289	11	94	858	22	28	26	84	41	125
EXPENSES	TOTAL	19,647	152	1,251	13,473	706	348	751	982	574	1,410
	INTEREST	7,388	60	472	4,966	379	168	168	385	240	551
	SALARIES	4,248	46	288	2,915	158	61	88	258	100	334
	LOAN LOSS PROVISION	2,241	5	96	1,714	31	19	152	74	56	94
	OTHER	5,770	42	395	3,878	138	100	343	264	178	431
INCOME BEFORE TAXES		2,993	57	53	1,595	192	88	288	253	130	337
TAXES		1,186	17	27	705	69	30	98	85	43	111
NET INCOME		1,807	40	39	876	122	59	190	167	87	226
ROA (%)		0.75	1.78	0.25	0.54	1.16	1.22	2.59	1.37	1.26	1.17
ROE (%)		9.62	13.31	2.62	7.47	16.18	16.52	25.68	14.96	14.59	13.24
NET INTEREST MARGIN (%)		4.40	4.97	3.62	4.30	4.02	4.34	7.94	4.77	4.88	4.34
ASSET QUALITY -- PERCENT OF LOANS (LARGE COMMERCIAL BANKS)											
LOAN LOSS RESERVE (ALL BANKS)		3.02	1.94	2.89	3.28	1.64	1.50	4.04	2.59	2.47	2.08
NET CHARGEOFFS, TOTAL		1.04	0.29	1.25	1.11	0.22	0.37	3.18	0.73	0.98	0.49
	REAL ESTATE	0.59	0.05	1.11	0.69	0.07	0.03	0.50	0.16	0.32	0.07
	COMMERCIAL	0.98	0.58	3.23	0.99	0.31	0.58	0.36	1.17	0.94	0.59
	CONSUMER	3.14	0.38	1.66	4.07	0.90	0.57	5.14	1.58	1.92	1.13
	AGRICULTURE	0.09	0.00	0.14	-0.13	0.00	0.56	0.00	0.12	1.33	0.23
PAST DUE & NON-ACCRUAL, TOTAL		6.19	4.43	4.55	7.24	2.15	2.07	5.89	3.85	2.97	4.23
	REAL ESTATE	7.75	5.47	7.05	8.60	2.39	2.49	7.38	5.02	3.68	6.63
	CONSTRUCTION	18.58	11.39	22.29	19.52	7.36	6.55	13.98	12.44	3.14	19.81
	COMMERCIAL	8.15	6.04	10.84	9.43	1.24	3.24	6.58	5.77	4.54	4.00
	FARM	8.03	0.00	29.49	8.36	10.94	5.85	0.00	1.67	9.88	2.70
	1-4 FAMILY REV	1.13	0.61	0.86	1.24	0.89	0.21	0.58	0.64	0.88	0.78
	1-4 FAMILY OTHER	2.74	2.13	2.65	2.97	2.23	1.25	3.39	1.49	2.09	1.70
	MULTI-FAMILY	7.93	1.26	12.90	8.56	0.69	1.53	31.74	7.90	0.75	3.92
	COMMERCIAL	6.70	3.96	8.99	7.66	2.15	2.17	7.97	4.71	3.59	3.42
	CONSUMER	3.26	2.45	2.41	3.90	2.07	1.41	5.14	1.50	2.07	1.63
	AGRICULTURE	5.56	0.00	6.99	6.72	1.44	3.22	1.31	4.44	3.13	4.34
NUMBER OF BANKS		756	8	38	459	19	20	18	49	54	91
NUMBER OF EMPLOYEES		243,154	2,632	19,514	157,142	8,312	4,791	5,935	15,571	7,108	22,149

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MARKET SHARE STATISTICS

DEPOSITORY INSTITUTIONS REQUIRED TO HOLD RESERVES WITH THE FEDERAL RESERVE ON A WEEKLY BASIS

PERCENT OF COMBINED MARKET TOTAL FOR AUGUST 1992, BY REGION

	DISTRICT			ALASKA			ARIZONA			CALIF			HAWAII			IDAHO			NEVADA			OREGON			UTAH			WASH		
DEPOSIT TYPE	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU
TOTAL DEPOSITS	54	40	6	72	4	24	92	0	7	48	46	5	67	27	6	92	5	3	73	24	3	80	11	9	78	8	14	56	35	9
DEMAND	91	4	5	98	0	2	96	0	4	90	5	5	89	4	7	95	0	5	97	3	0	94	1	5	89	4	6	90	6	4
NOW	64	28	8	60	6	34	89	0	11	58	35	6	67	30	3	94	3	3	78	16	6	84	8	8	83	4	13	64	24	12
SAVINGS & MMDAS	60	32	8	56	4	40	90	0	10	56	38	6	60	32	8	93	4	3	82	14	4	76	11	13	71	6	23	57	26	17
SMALL TIME	33	64	3	75	9	17	95	1	5	24	73	3	50	47	3	89	10	1	42	55	3	76	18	6	78	15	7	39	56	4
LARGE TIME	47	45	8	94	2	4	94	0	6	41	50	9	82	15	4	89	6	5	62	38	0	75	12	13	72	10	17	49	49	2

CB = COMMERCIAL BANKS; SL = SAVINGS & LOANS AND SAVING BANKS; CU = CREDIT UNIONS; MAY NOT SUM TO 100% DUE TO ROUNDING

INTEREST RATES ON DEPOSITS AND LOANS AS OF AUGUST 1992 (%)

TYPE OF ACCOUNT OR LOAN		DATE	US	DISTRICT	ARIZ	CALIF	HAWAII	IDAHO	OREGON	UTAH	WASH
SAVINGS ACCOUNTS AND MMDAS**		JUN 92	3.53	3.66	3.23	3.52	3.90	4.03	3.43	3.79	3.63
		JUL 92	3.24	3.36	2.96	3.14	3.54	3.77	3.16	3.55	3.43
		AUG 92	3.14	3.28	2.83	3.08	3.40	3.69	3.14	3.42	3.39
92 TO 182 DAYS CERTIFICATES		JUN 92	3.78	3.74	3.40	3.55	4.05	3.80	3.55	3.91	3.97
		JUL 92	3.45	3.40	3.08	3.26	3.17	3.56	3.37	3.64	3.68
		AUG 92	3.36	3.34	3.03	3.23	3.17	3.39	3.37	3.55	3.58
2-1/2 YEARS AND OVER CERTIFICATES		JUN 92	5.39	5.16	4.47	4.95	5.63	5.81	5.03	5.42	5.43
		JUL 92	5.02	4.78	4.32	4.52	4.78	5.56	4.97	5.03	4.79
		AUG 92	4.87	4.75	4.40	4.29	4.78	5.41	5.05	4.94	4.75
COMMERCIAL, SHORT TERM*	AVG. RATE		5.13	6.16	7.14	6.03	6.77	N/A	6.40	4.12	6.17
	AVG. MAT. (DAYS)		59	90	183	172	102	N/A	137	18	32
COMMERCIAL, LONG-TERM*	AVG. RATE		6.50	7.73	7.92	8.25	N/A	N/A	N/A	8.75	N/A
	AVG. MAT. (MONTHS)		45	32	25	26	N/A	N/A	N/A	53	N/A
LOANS TO FARMERS*	AVG. RATE		8.31	6.76	6.81	6.73	N/A	7.78	6.47	8.17	7.14
	AVG. MAT. (MONTHS)		17	16	7	16	N/A	N/A	18	61	11
CONSUMER, AUTOMOBILE	AVG. RATE		9.15	9.39	9.90	9.24	N/A	10.50	8.79	8.50	9.41
CONSUMER, PERSONAL	AVG. RATE		13.94	13.77	13.75	13.77	N/A	11.00	12.26	16.00	12.81
CONSUMER, CREDIT CARDS	AVG. RATE		17.66	18.36	18.00	18.98	N/A	N/A	19.25	21.00	17.93

SOURCES: SURVEY OF TERMS OF BANK LENDING AND TERMS OF CONSUMER CREDIT; MOST COMMON INTEREST RATES ON SELECTED ACCOUNTS.
* DATA ARE COMPOUNDED ANNUAL RATES. **SAVINGS AND MMDAS COMBINED AS OF JULY 1992